STATEMENT OF

JOHN COOK

DIRECTOR PETROLEUM DIVISION

ENERGY INFORMATION ADMINISTRATION

BEFORE THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES

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Rising Crude Oil and Gasoline Prices

Thank you, Mr. Chairman. I would like to begin by thanking the Committee for the opportunity to testify on behalf of Mark Mazur for the Energy Information Administration (EIA).

With gasoline prices at $1.59 nationwide, compared to $1.16 on average last July, consumers want an explanation. In EIA’s view, this summer’s run-up, like other recent price spikes, stemmed from a number of factors. The stage was set for gasoline volatility as a result of tight crude oil supplies, which led to low crude oil and low product stocks and high crude oil prices. With little stock cushion to absorb unexpected events, Midwest gasoline prices surged when a number of supply problems developed, including pipeline and refinery supply problems, and a difficult transition to summer-grade Phase II reformulated gasoline (RFG).

Crude oil continues to be an important factor in explaining price increases over year-ago levels. West Texas Intermediate (WTI) crude oil prices have risen from a low point in December 1998 of under $11 per barrel to $34 recently. While $34 is far from the inflation-adjusted $70-per-barrel historical highs seen in 1981, for many, the pace of these increases may be as disruptive as the higher absolute levels. From a year-ago June, crude oil price increases have contributed about 33 cents per gallon to the increase in the price of gasoline.

Crude oil prices rose as a result of a shift in the global balance between production and demand. Crude markets tightened in 1999 as OPEC and several other exporting countries reduced supply, while, at the same time, the economic recovery in Asia stimulated demand growth. In 1999, world oil demand exceeded production by over 800 thousand barrels per day, reducing world inventories by about 300 million barrels. By the end of 1999, global inventories were at very low levels – especially in the United States as shown in Figure 1.

In 1999, as markets tightened, crude oil prices rose faster than product prices, squeezing refinery margins, discouraging refinery production of all products, and thereby adding to downward pressure on inventories. Figure 2 shows that in June 1999, the difference between wholesale gasoline prices and WTI crude oil prices averaged less than 6 cents per gallon, compared to the more typical 10-12 cents per gallon seen at that time of year. However, by spring 2000, low crude oil and product stocks generated much higher product prices relative to crude oil. Where the wholesale margins were low last year, they are now high at about 20 cents per gallon, 14 cents higher than in June last year. That is, the low gasoline inventories are probably adding about 10 cents per gallon to the price of gasoline over what we would typically expect this time of year. Yet some regions have experienced much higher price increases since June 1999 than the 47-cent calculation implied here (33 cents from crude oil and 14 cents from wholesale gasoline margins).

EIA has pointed out on several occasions that very low gasoline stocks, combined with a market short on crude oil, generates an environment ripe for price volatility. The West Coast experienced such volatility in February and early March, and the Midwest erupted in May. Several pipeline and refinery problems in the Midwest caused already low stocks to fall to 13 percent below their 5-year average by the end of May. In comparison, U.S. gasoline inventories were only 5 percent below average.

With inventories in the Midwest at extremely low levels, prices were bid up rapidly as marketers scrambled for limited supplies of both conventional and RFG. As shown in Figure 3, both RFG and conventional prices rose quickly, but RFG began rising earlier and at a faster pace. RFG prices in the Chicago and Milwaukee areas drew most of the attention initially as these prices increased more than 30 cents per gallon over conventional prices in the surrounding areas.

As shown in Figure 4, the Midwest RFG price increases appeared to be similar to price surges often seen in California since the start of their RFG program. There are several reasons for this strong price response:

- The Midwest RFG market is small (13% of Midwest gasoline), which limits nearby supply options;
- This was the first year of Phase II RFG, and some refiners had difficulty making the transition from winter to summer grade. In the Midwest, ethanol is used to make RFG, which requires a unique blend of gasoline components with very low vapor pressure (i.e., tendency to evaporate). In several cases, refiners had to bring gasoline components in from other refineries to meet the new gasoline specifications;
- The large change in gasoline specifications for summer-grade RFG resulted in different refineries in the Midwest producing different amounts of RFG than in prior years. While each refinery produced enough to meet its own company's marketing needs, some produced extra RFG and some were unable to produce at historical levels. That is, independent marketers had to scramble to find new supply sources in a market that was initially very tight.
- Finally, with few alternative sources of readily available supply, it took time for the

supply/demand imbalances to be resolved. The RFG markets in the Chicago/Milwaukee areas and California are alike in that they are isolated and use unique gasoline blends. Less than 10 refiners supply the Chicago/Milwaukee areas. They responded to the incentive for more supply by arranging for blending components to be brought in from the Gulf Coast – a process that took several weeks.

Today, the U.S. refinery system has little excess capacity, and continuing growth in the number of distinct gasoline types that must be delivered to different locations increases the potential for temporary supply disruptions and increased volatility.

Fortunately, wholesale prices in the Midwest began declining in the first half of June, reflecting increasing supplies, as confirmed by EIA's weekly data. Midwest gasoline stocks have climbed 15% since the end of May and have returned to near normal levels for June. RFG retail prices fell 37 cents per gallon and conventional gasoline fell over 26 cents during the past three weeks.

While the first hurdle of the transition to summer-grade gasoline is behind us, we may experience more volatility before the summer is over. Midwest stocks are recovering, but East Coast gasoline stocks at the end of June were 8 percent below their 5-year average, with RFG 13% below average. California gasoline stocks were 6% below average. Consumers are not expected to reduce consumption much in the short term. As we enter the peak gasoline season, refiners will be pushed to just meet demand. With low stocks and refineries operating at high levels, any supply disruptions could trigger another price runup.

In closing, I want to direct your attention to the upcoming heating season. Although consumers are now focusing on gasoline, EIA is concerned about winter heating fuel supplies. Distillate stocks remain well below normal. Even with a typical inventory build this summer, we likely will enter the winter heating season with lower-than-normal stocks. Strong gasoline and diesel demand this summer will effectively limit heating oil stock building as refinery production is used to meet consumption.

Partly for the same reasons, natural gas has yet to show signs of building adequate inventories ahead of next winter. Not only does this mean industrial and utility consumption of more distillate this winter, it suggests utilities may use more distillate this summer to meet peak cooling needs, if natural gas prices remain high through the summer months. This could further reduce distillate stock building, resulting in very low distillate inventories before winter begins.

This concludes my testimony. I would be glad to answer any questions.

Figure 1

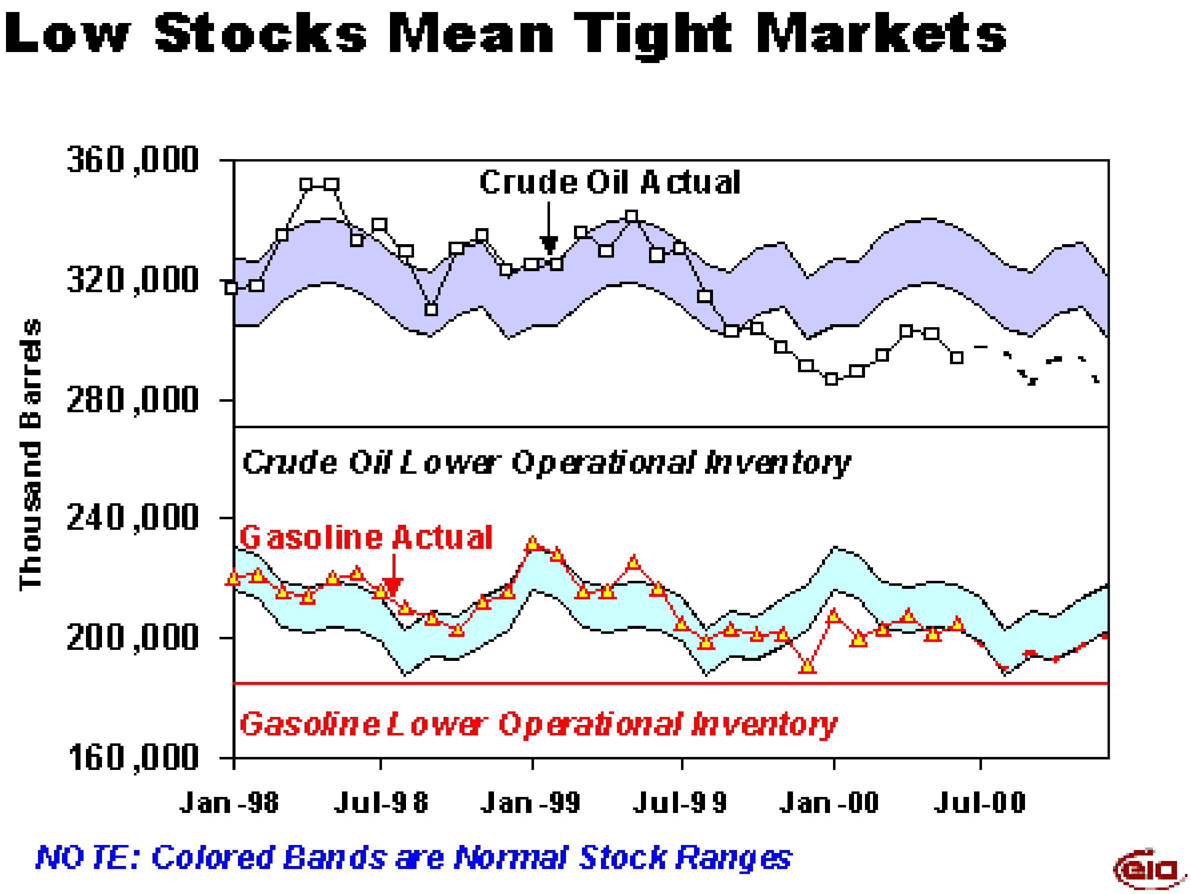
Low Stocks Mean Tight Markets
360,000
320,000
280,000
240,000
200,000
160,000
Thousand Barrels
Crude Oil Actual
Crude Oil Lower Operational Inventory
Gasoline Actual
Gasoline Lower Operational Inventory
Jan-98
Jul-98
Jan-99
Jul-99
Jan-00
Jul-00
NOTE: Colored Bands are Normal Stock Ranges
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Figure 2

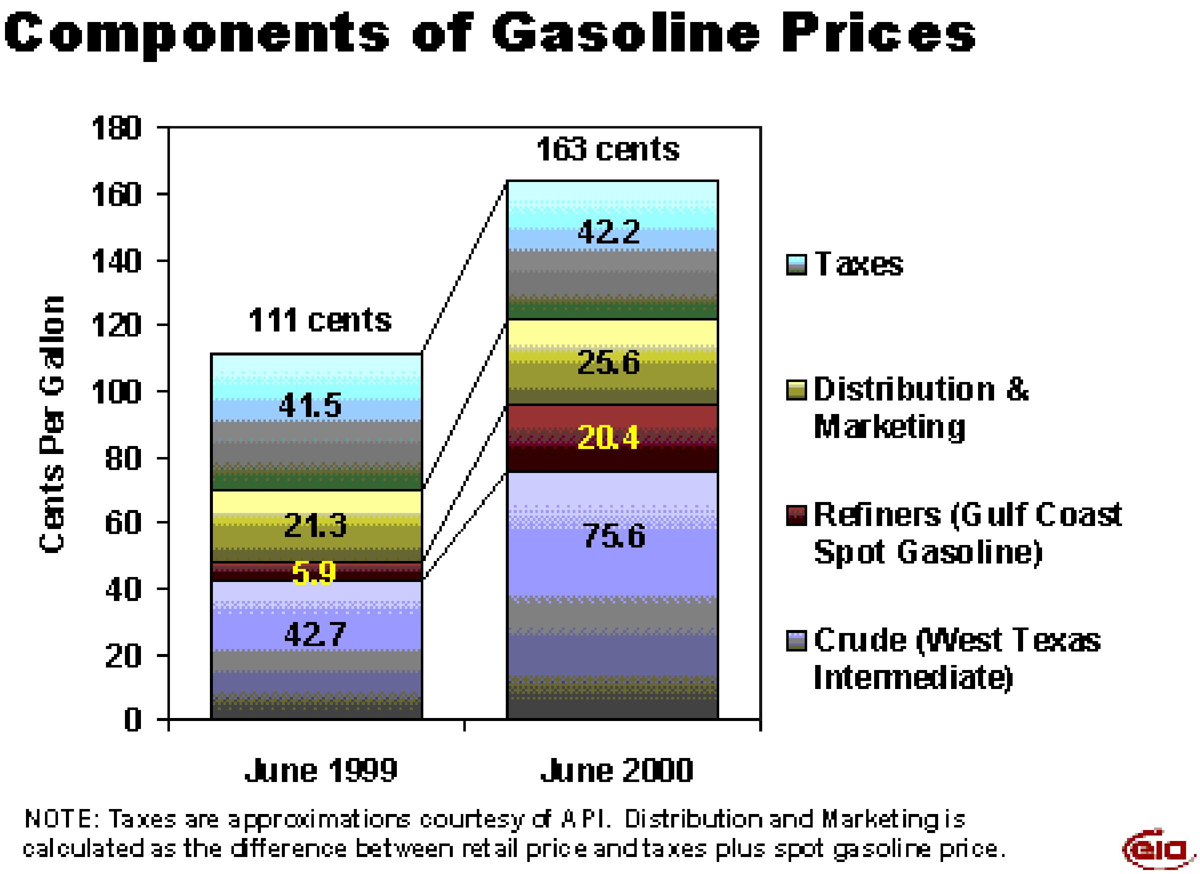
Components of Gasoline Prices
180
160
140
120
100
80
60
40
20
0
Cents Per Gallon
111 cents
41.5
21.3
5.9
42.7
163 cents
42.2
25.6
20.4
75.6
June 1999
June 2000
Taxes
Distribution & Marketing
Refiners (Gulf Coast Spot Gasoline)
Crude (West Texas Intermediate)
NOTE: Taxes are approximations courtesy of API. Distribution and Marketing is calculated as the difference between retail price and taxes plus spot gasoline price.
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Figure 3

Midwest Prices Surged in May and June

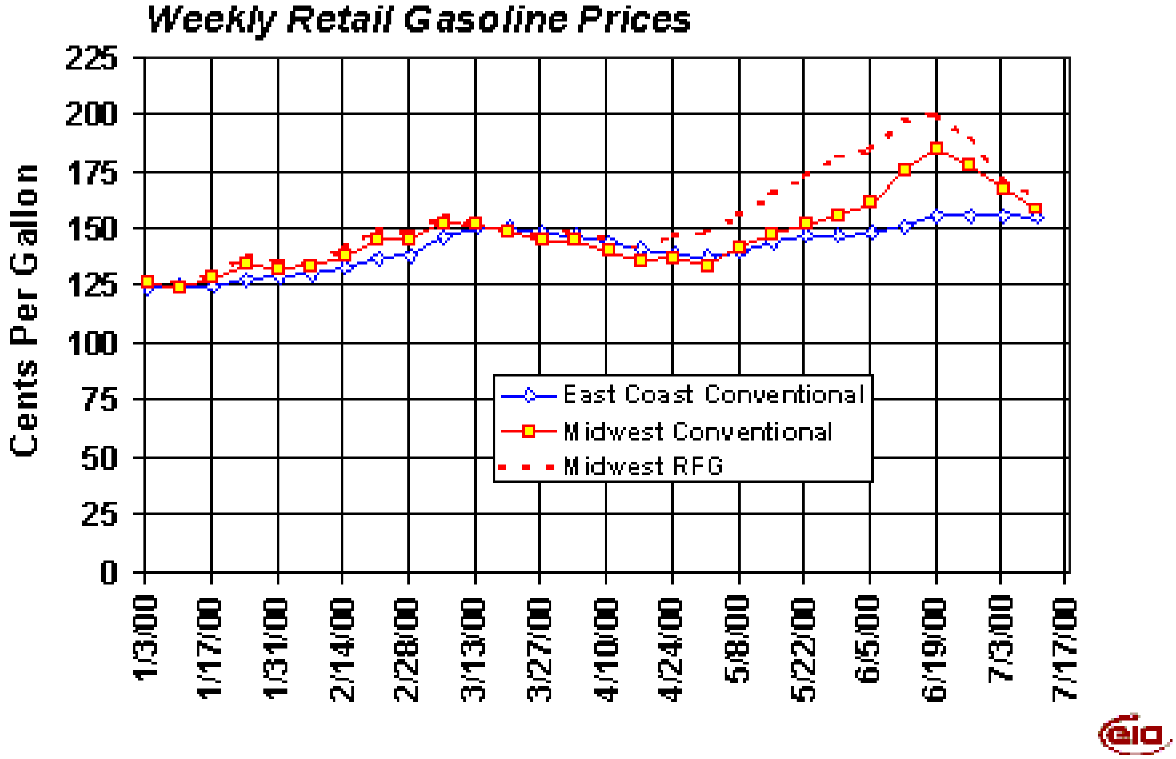

Figure 4

Midwest Price Surge Followed CA Surge